Tax Dispute Resolution

Blackrock Holdco 5 LLC v HMRC - Court of Appeal decision on unallowable purpose and transfer pricing

The Court of Appeal (**"CA"**) has handed down its decision in the *Blackrock* appeal. This case concerned the deductibility of interest by companies under both the "Unallowable Purpose Rule" (CTA 2009, ss441-442) and the transfer pricing (**"TP"**) rules. This is a significant decision given that both of these areas continue to be actively challenged by HMRC in practice.

In brief, the case involved a US-headed group using a debt-funded UK SPV (**"LLC5"**) as part of the acquisition structure for acquiring a US target. HMRC challenged the deductibility of the interest in LLC5 under the Unallowable Purpose Rule, arguing that the borrowing had a main purpose of obtaining a UK tax advantage and that on a just and reasonable basis it should be fully disallowed. HMRC also challenged the deductibility of the interest under the TP rules, arguing that the loan would not have been entered into between parties acting at arm's length.

The CA found in favour of HMRC on the Unallowable Purpose Rule and in favour of the taxpayer on the TP rules. This decision may be appealed by either or both parties to the Supreme Court. It will also be followed over the coming months by decisions from the CA in several other cases concerning the Unallowable Purpose Rule.

Key takeaways on Unallowable Purpose Rule

Although a win for HMRC, the Court emphasised that the decision depended on what the evidence showed about the facts and circumstances of the case. This included the fact that a UK SPV was used whose *"sole raison d'être"* was to enter into the borrowing in order to obtain tax advantages for the group. The Court highlighted the particular features of the acquisition structure and surrounding facts, and helpfully noted the following:

> *"...It does not follow that other debt incurred in connection with a commercial acquisition – as the acquisition of BGI US undoubtedly was – would fall foul of the unallowable purpose rule even if the decision to borrow had regard, as it often would, to tax considerations...."* (Para 171)

Key points made by the CA in its decision:

- The CA accepted that the LLC5 board had a commercial purpose in borrowing to acquire a valuable asset. However, the LLC5 board were aware of the UK tax purposes that had driven the inclusion of LLC5 in the design of the acquisition structure. Although the unallowable purpose rule tests the subjective purposes of the board of the borrowing company in being party to borrowing rather than the purposes of the scheme or arrangement, the CA regarded it as unrealistic on the facts of the case to divorce the board's borrowing decision from the wider context. This is likely to encourage HMRC to continue its existing approach of looking to have regard to the wider factual context when conducting Unallowable Purpose Rule enquiries.

- The fact a beneficial tax effect is obtained as an inevitable and inextricable consequence of borrowing should not automatically be taken to mean there is a tax purpose, whether conscious or subconscious. The CA acknowledged that the obtaining of tax relief will often form part of the *"ordinary decision-making processes about methods of funding a company"* and that *"it cannot have been Parliament's intention that the inevitable consequence of taking out a loan should engage the unallowable purpose rules"* absent more. Taxpayers may find this clarification helpful.

- Where there are mixed main tax and commercial purposes, it is necessary to determine a just and reasonable apportionment by reference to the subjective purposes. This is fact-specific, and different approaches may be appropriate in different cases. The CA was open to the principle of using a proportional allocation in the right circumstances. Also, the "but for" approach (i.e. asking what would have happened "but for" the main tax purposes) appears to have been seen by the CA as a useful litmus test. This will all be of interest to taxpayers in the middle of discussions with HMRC about the application of the just and reasonable apportionment to their case.

Blackrock [cont.]

This decision may encourage HMRC to continue to ask questions relating to the Unallowable Purpose Rule in cases where a debt-funded UK SPV is established to make an acquisition, in particular.

More generally, this decision illustrates that the Tribunal/Courts are likely to take an holistic view of the evidence relating to the implementation of UK company borrowing. What that wider evidence shows is key to determine both the subjective intentions of the borrowing company and whether it can be said that absent any tax benefits the borrowing would or would not have occurred. Taxpayers may benefit from engaging with these evidential considerations at the earliest opportunity. In particular, groups establishing a debt-funded UK SPV to make an acquisition may benefit from ensuring that they can appropriately evidence any commercial rationale that may have led to the SPV being used in the structure.

Key takeaways on Transfer Pricing ("TP")

The Upper Tribunal ("**UT**") found that the TP rules did not permit third party covenants (to protect the earnings available to the borrower) to be hypothesised where they did not already exist. The CA disagreed with the UT's analysis and found in favour of the taxpayer on this point.

Key points:

- The CA concluded that there was nothing in the UK legislation or OECD guidelines which requires the position of third parties to be ignored. Note that in this context "third parties" refers to parties which are not the lender or borrower (as opposed to being unconnected parties for transfer pricing purposes).
- The CA noted that based on the facts of the actual transaction, third party covenants would not have been required due to the relationship between the lender, the relevant third parties and the borrower. In particular, the CA noted that the lender controlled the income stream of the borrower independently from its connection with the borrower. Accordingly, the CA concluded that the lending transaction would have occurred at arm's length between an unconnected borrower and lender.
- We highlight that the specific facts (i.e. the relation between the lender, borrower and third parties) proved significant in the CA reaching the conclusion that third party covenants would not have been required in the actual transaction in this case. Taxpayers on a comparable or analogous factual footing to Blackrock may be able to take some comfort from this decision. In arrangements where the borrower does not have such control of the income generating assets which support the debt, the inclusion of actual covenants may still be recommended. In any event, it remains important for taxpayers to take care when assessing the risk profile of intragroup transactions when undertaking their transfer pricing analysis, particularly in cases where there may be a question-mark over a borrowing entity's ability to control an income stream it is dependent upon.

PwC contacts

PwC's tax practice combines multidisciplinary expertise across transfer pricing, international tax, disputes & litigation. Please do not hesitate to get in touch with your usual PwC contact and/or any of the individuals listed below.

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